NBB Business Echo

June 2023

Economic conditions have further improved as price pressures recede

- Business Echo interviewees confirm that economic conditions have continued to improve. Despite an uncertain outlook, Belgian companies generally expect their activity to expand further, albeit possibly at a slower pace.
- Companies expect input prices to normalise further in the near term. The effects of the energy crisis are fading and – with the notable exception of the food processing industry – post-pandemic supply chains problems have largely been resolved. The pass-through of costs to sales prices has increased but remains partial. Most firms feel that it is becoming increasingly difficult to raise prices, which should lead to a further easing of inflation in the near term.
- Despite higher wage costs, most companies maintained or expanded their permanent workforce in the second quarter and prospects for the coming months are mostly stable. Due to structural labour market tightness, Belgian firms are reluctant to lay off employees.
- Investment plans do not appear to have been curtailed, despite pressures on margins and a less favourable external financing environment. Companies often have pre-approved bank credit lines with beneficial terms or report that their investments are nearly interest-rate insensitive due to a rapid expansion of activity or sufficient intra-company or intra-group liquidity. Firms are continuing their digitalisation efforts; both the structurally tight labour market and large wage increases encourage productivity-enhancing investments.
- The current divergence in activity between manufacturing and services may narrow. Interviewees in the manufacturing industry indicated that, overall, business conditions have improved and are bullish in the near term despite the recent worsening of manufacturing sentiment revealed by the NBB's monthly business survey. Prospects for the longer term remain more uncertain with companies pointing to worsening cost competitiveness. As regards the services sectors, activity is generally reported to have clearly expanded recently and should continue to do so in the coming months. However, in certain industries (non-food retail and hospitality) the upswing could lose traction.
- The continued optimism about current and future activity is common to all three regions; if anything, the assessment of companies based in the Walloon Region was particularly upbeat. This seems a bit at odds with the headline regional business sentiment measured by the NBB's monthly surveys.

The NBB Business Echo is a qualitative, production-side assessment of the current economic situation in Belgium. It is based on a combination of information gathered, among other things, through targeted interviews with business leaders across Belgian Regions and industries and various other sources, such as the NBB's monthly surveys. While these surveys allow an analysis based on a representative sample, the interviews conducted with companies as part of this Business Echo provide additional information on the dynamics and context that cannot always be captured in standardised surveys. This issue was based on around 40 interviews held between 17 April and 15 May 2023. The NBB Business Echo supports our macroeconomic analysis and is an important input for the Business Cycle Monitor which provides a quantitative estimate of quarterly growth and is typically published shortly after the Business Echo.

While uncertainty remains high, business conditions have improved and inflation has most likely peaked

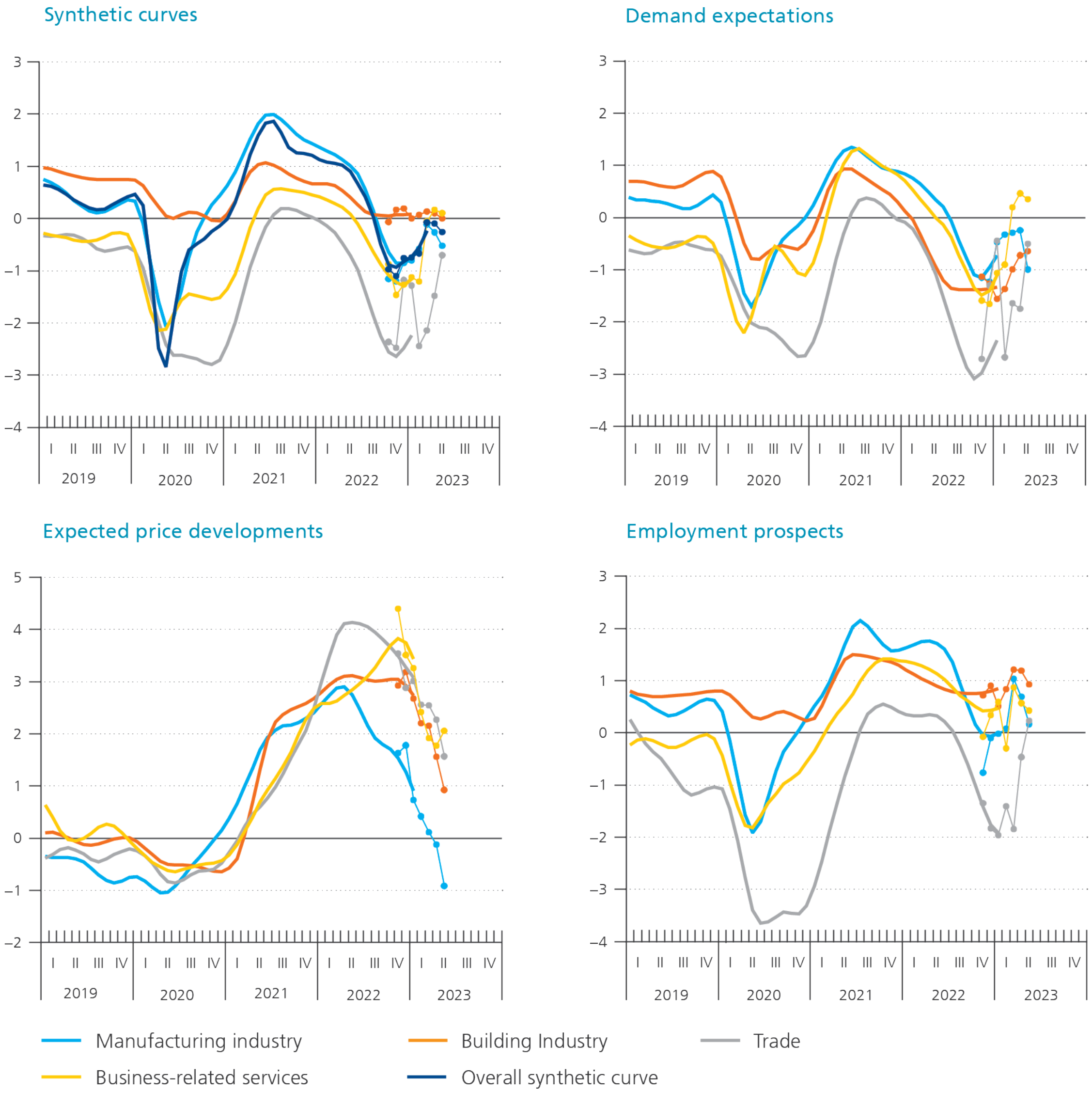
In the targeted interviews conducted for this Business Echo issue, companies generally indicated that economic conditions have improved. While the circumstances remain challenging, businesses suggested on average a further increase in activity in the second quarter of 2023 and, to a lesser degree, in the third quarter. This is broadly in line with the developments in producer sentiment, as measured by the NBB business surveys. Headline business confidence worsened markedly in the second half of 2022 but started to recover in the fourth quarter. The uptick in confidence lost steam in recent months, however, with May seeing a minor deterioration. If confirmed, this could indeed suggest a slight slowdown in economic activity in the second half of the year.

Price pressures should have peaked. Input prices were reported to have increased across all Belgian Regions and nearly all industries. However, most business leaders believe that the worst is now behind us and – with the notable exception of some food processing companies – indicated that the bulk of the (post-pandemic) supply chains problems has been resolved and a further normalisation is expected in the coming months. The general feeling is that, overall, input price developments would continue to moderate into the third quarter. Increased costs have been passed on to sales prices. This was particularly the case for companies with stronger pricing power that benefit from long-term contracts with broad price-adjustment clauses. However, for many companies across all industries, the pass-through has been only partial, and most firms feel that it is becoming increasingly difficult to further hike sales prices. The reasons for this vary from industry to industry. Some firms report softening demand and overcapacity, while others, more exposed to the global market, expressed concerns about their international competitiveness. As a result, the increase in sales prices is expected to ease quickly. This is fully in line with the results of the NBB's monthly business survey: expected price developments across all industries are falling fast (see chart 1, bottom left).

Companies generally did not report substantial downward revisions of their investment plans. This is despite the fact that margins are perceived as quite low and the less favourable external financing conditions. As regards the latter, companies indicated that financing conditions were tightening – which is in line with the strong rise in credit constraint perception noted in the NBB's most recent quarterly survey on credit conditions – and banks have reportedly become more conservative in their approval of new loans. Interestingly, this latter point was not confirmed by contacts in the banking industry. However, most companies felt that the current interest rate environment is still quite favourable, from a historical perspective, and does not yet constitute a strong impediment to business investment. Companies, in particular larger ones which account for most investment, tend to have sufficient internal or intra-group liquidity. In addition, they can often use pre-approved bank credit lines with beneficial terms. As regards the type of investment, firms are generally continuing their digitalisation efforts, and many cited the structurally tight labour market and large wage increases as reasons to expand productivity-enhancing investments. Many interviewees also mentioned a continued need to invest in the "greening" of production processes due to regulatory constraints and increasingly expensive emissions rights. Investment plans are nearly always part of a business strategy over a longer time horizon and, hence, do not necessarily react immediately to changes in the business or financial environment. Companies that scale back investment are often highly dependent on large amounts of external financing or cited overcapacity or an increasing regulatory burden as the main reasons for doing so. Competitiveness issues were a factor that came up more often among respondents that form part of international groups, which reported having difficulty "selling" new investments in their Belgian branch to their headquarters.

Chart 1

Business sentiment and relevant sub-indicators by industry
(normalised series)



Source: NBB business survey

Turning to employment, the situation and outlook remain favourable at the current juncture. Despite concerns about wage costs, margins and international competitiveness, most businesses report having maintained or expanded their permanent workforce, and prospects for the coming months are mostly stable. In the interviews, a vast majority of firms reported experiencing structural worker shortages in their field, even in industries where wages and working conditions can be considered attractive. This makes them reluctant to reduce their permanent workforce. Those that did cut back are often active in industries characterised by a high degree of (international) competition and were unable to absorb the increase in wage costs due to automatic indexation. However, only a small minority reduced their permanent workforce. Some companies reported saving on labour-related costs by reducing the number of flexible contracts (e.g. external contractors) while others reported being in the process of reassessing their consultancy expenditure. This distinction between the permanent and temporary workforce could explain the difference between the job stability reported during interviews and the recent dip in employment prospects revealed by the NBB's business survey (see chart 1, bottom right), although the latter also appear to have rebounded in recent months.

Sentiment remains more positive in the services sectors, while the near-term outlook in manufacturing industry has improved as well

As elsewhere in the world, economic conditions are better for services than in manufacturing industry. According to current statistics for the first quarter of 2023, activity again expanded strongly in the services sector, while value added in the manufacturing industry continued to fall, albeit to a lesser degree than at the end of 2022. The minor worsening in business sentiment seen in the last two months, as measured by the NBB's monthly survey, is due almost entirely to manufacturing, which is overweighted in the overall headline confidence indicator (see chart 1, top left). Sentiment in the services sector (and in the building industry) held up much better.

Business Echo interviews suggest that upbeat sentiment is broad-based across industries and tend to indicate broadly favourable conditions in the manufacturing industry as well. Interviewees from the latter industry indicated that, overall, their situation has brightened somewhat compared to previous quarters, as the fundamentals improved. They reported that activity was holding up or even recovering. Several energy-intensive companies stated in particular that production lines that had been shut down in the autumn have now been restarted, although a full recovery is not yet feasible as even at current prices the production cost of certain goods still exceeds global market prices. They also seemed more upbeat on the near-term outlook than respondents to the NBB's monthly business survey: in general, interviewees did not confirm the deterioration in manufacturing firms' demand expectations revealed by the May business survey (see chart 1, top right). However, some manufacturing interviewees indicated that while their order books are recovering in the current quarter, the outlook for the second half of the year and beyond is increasingly uncertain. Manufacturers of construction materials, for example, were concerned about the fall-out from higher mortgage rates and the slowdown in lending for new real estate projects. Some managers of energy-intensive firms also pointed to a structural deterioration in Belgian and European competitiveness and indicated that their firms have already shifted their focus for additional production capacity to other continents, in particular North America, due to cheaper local energy. In addition, relatively strict environmental requirements and an inefficient regulatory process were cited as further impediments to growth and investment.

Turning to the nominal side, price pressures in the manufacturing industry are cooling progressively due to much lower energy prices as well as the normalisation of supply chains. Most interviewees in the manufacturing industry also indicated that the bulk of the additional costs they faced have by now been passed through to sales prices. Those firms that were most pessimistic about their current margins are active in highly competitive environments or have been unable to adjust their prices or costs due to contractual lock-ins.

As regards the services sectors, the upbeat signals from the NBB's monthly business survey were by and large confirmed in Business Echo interviews. Activity was generally reported to have clearly expanded recently and should continue to do so in the coming months. Any slowdown should be limited and seems to be concentrated in specific industries. While demand expectations appear to have levelled off somewhat for business-related services, they continued to improve in May for the trade sector (see chart 1, top right). Judging from the Business Echo interviews, there is some divergence between business-to-business (B2B) and business-to-consumer (B2C) industries. Some interviewees from logistical companies that directly depend on the manufacturing industry noted that demand was gradually recovering from a dip in the first quarter of the year. As regards broader business-related services, demand remains solid. Although some interviewees pointed to vulnerabilities to cost-cutting decisions in the broader economy, services activity should continue to grow moderately in the coming months. Business-oriented ICT services, in particular, expanded vigorously in the past quarter and should continue to do so in the near future as such services benefit from the general trend towards greater digitalisation. The messages were somewhat more mixed in B2C industries. Interviewees in non-food retail reported that demand has weakened recently with companies also flagging a renewed increase in inventories. At the same time, businesses in the hospitality industry indicated that they are still benefiting from the post-pandemic recovery, although demand is starting to react to a further pass-through of input costs.

Recent wage indexation posed however a particular challenge for the competitiveness of more labour-intensive manufacturing activities and the usually more labour-intensive services sectors. Many of these firms reported that their margins had been hit hard, although, with some lags, many were apparently also able to pass through these costs to their customers, often through explicit contractual clauses. Increases in “less visible” costs such as rent and higher energy costs for warehouses, for example, were said to be much harder to offset. The (partial) pass-through of these costs seems to have gone more smoothly for larger companies than smaller ones. Firms that form part of a multinational group or that are exposed to (international) competition were also more likely to express the need to compensate for higher costs – most notably the indexation of wages – through productivity gains and, if necessary, workforce adjustments.

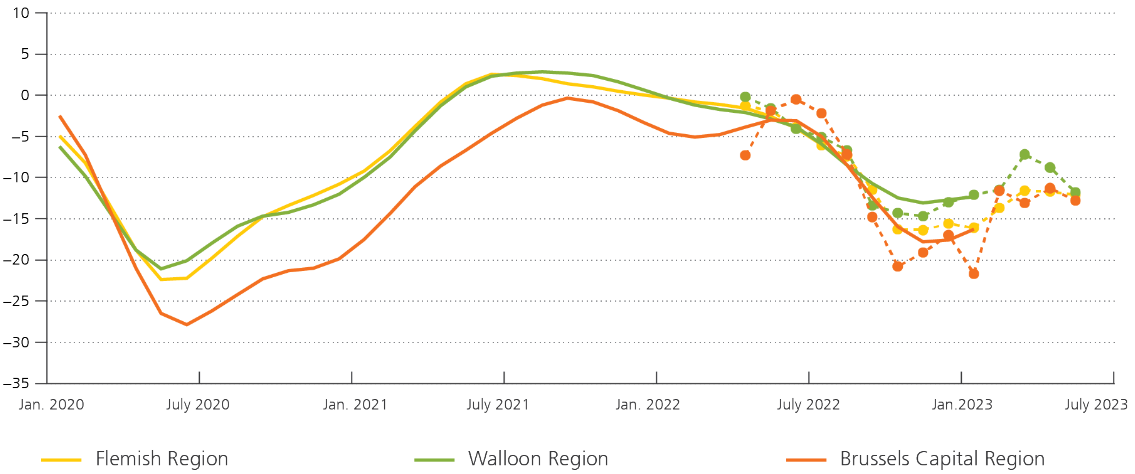
There are relatively few indications that large cost increases will weigh on new investment projects. Negative signals were mostly idiosyncratic: certain Business Echo interviewees from local branches of multinational manufacturing companies stated that recent wage indexation was detrimental to their business case when vying for new project budgets. At the same time, however, the pharmaceutical industry, which accounts for a sizeable share of Belgian manufacturing and for which new product lines have very long lead times, reported investing in new products and facilities. As in manufacturing, businesses in the services sectors rarely cited the rising cost of external financing as a factor hampering investment decisions. Interviewees from branches that are highly dependent on financing costs, such as real estate developers, were the most notable exceptions. The viability of new investment projects by these highly capital-intensive firms depends on interest rates, with banks reported to have become more selective when granting new funding. For these firms, the near-term activity outlook was often quite uncertain. The residential real estate market appears to be holding up much better: both real estate agents and construction companies suggested that the decline in activity had bottomed out in the first quarter and a tentative pick-up has since been observed.

Sentiment of firms in the Walloon Region seems to remain more resilient than suggested by the NBB’s monthly business survey

According to the NBB’s monthly business survey, sentiment has worsened recently for firms based in the Walloon Region (see chart 2). Business confidence was more stable in the other two Regions.

Chart 2

Business sentiment by Region



Source: NBB business survey

This regional divergence is not confirmed by Business Echo interviews. If anything, overall, companies based in the Walloon Region even seem slightly more optimistic regarding their current situation and business prospects than those in the other two Regions. Differences between the signals from the Business Echo interviews and the regional sentiment indicators could be due to sampling issues (the NBB's monthly survey covers many more firms) or the information gathering method (interviews versus surveys).

The findings of the Business Echo interviews appear in line with the analysis carried out by the regional employer federations. "Stabilisation before recovery?" is the more optimistic title of the latest economic assessment of the *Union Wallonne des Entreprises* (UWE). *Voka*, its Flemish counterpart, presents a more pessimistic message, emphasising that around 25% of its members have revised downwards their growth outlook and that "for the second quarter of this year, companies surveyed do not expect turnover to increase." Both organisations note that increasing wage costs have eroded corporate competitiveness. Regarding investment plans, UWE points to an expectation of cautious expansion, which is again a more optimistic message than that received from *Voka*, which expects investment to stagnate.

Overall, activity growth in the second quarter should remain firmly positive but could edge down later in the year

As regards the economy as a whole, the more qualitative results collected from interviews with business leaders are broadly in line with those of the NBB's monthly business survey and certain other high-frequency data. Activity growth in the second quarter of 2023 should remain firmly in positive territory. At the same time, interviewees confirm that uncertainty remains high for the future. While the sharp drop observed in May in demand expectations in the manufacturing industry was not reflected in the Business Echo interviews, information from other industries could point to a gradual slowdown in the summer. The post-pandemic recovery dynamics appear to be losing traction in the non-food retail and hospitality industries, partly due to past price increases.

These factors will be taken into account in the upcoming Business Cycle Monitor (BCM), which will be published on 9 June 2023. As usual the BCM will review current economic conditions through the lens of the main demand components and include a quantitative nowcast for quarterly growth in the second quarter.